

Federal Taxation - U.S. Supreme Court Rules on Useful Life and Salvage Value - *Hertz Corp. v. United States*, 346 U.S. 122 (1960); *Commissioner v. Evans*, 346 U.S. 92 (1960); *Massey Motors Inc. v. United States*, 346 U.S. 92 (1960)

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Recommended Citation

DePaul College of Law, *Federal Taxation - U.S. Supreme Court Rules on Useful Life and Salvage Value - Hertz Corp. v. United States*, 346 U.S. 122 (1960); *Commissioner v. Evans*, 346 U.S. 92 (1960); *Massey Motors Inc. v. United States*, 346 U.S. 92 (1960), 10 DePaul L. Rev. 212 (1960)

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If the limitation on the courts' transfer power is relaxed, the very threshold of the federal courts will be "cluttered" with preliminary trials of fact concerning the relative convenience of forums.⁴⁴ This might produce the very kind of uncertainty, hardship, and delay which the minority in the instant cases sought to avoid.

⁴⁴ *Ibid.*

FEDERAL TAXATION—U.S. SUPREME COURT RULES ON USEFUL LIFE AND SALVAGE VALUE

On the same day the United States Supreme Court considered three federal taxation cases concerning the points of useful life and salvage value. In the first case, petitioner was engaged in the business of leasing and renting trucks and automobiles. The average holding period of the trucks was thirty-nine months, and the automobiles were held for an average of twenty-six months. J. Frank Connor, former owner, claimed depreciation on a four year useful life using the straight line method for the trucks and a hybrid method for the automobiles for the fiscal years ending March 31, 1954, 1955, and 1956. Petitioner, successor to Connor, filed amended income tax returns for the above stated years using the declining balance method of depreciation, and claiming a refund. The Commissioner disallowed the amended returns and this was upheld by the Supreme Court of the United States. The Court held that the automobiles did not have a useful life of three years, required under section 167 (c) of the 1954 Internal Revenue Code,¹ and that therefore, the declining balance method of depreciation could not be employed. Although the Court found the trucks to have the required useful life, it held that they did not have a reasonable salvage value as required by Treasury Regulation section 1.167 (b)-2.² (The district court had previously held that useful life is the period of use to a taxpayer in his trade or business and that salvage value is inherent in the declining balance method.) *Hertz Corp. v. United States*, 346 U.S. 122 (1960).

In the second case, taxpayers were engaged in the business of leasing new automobiles. In the years 1950 and 1951, they leased numerous automobiles to Evans U-Drive, Inc., who in turn leased to the public. Taxpayers claimed depreciation over a useful life of four years with no

¹ Int. Rev. Code of 1954, § 167(c): "Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property . . . with a useful life of 3 years. . . ."

² Treas. Reg. § 1.167 (b)-2 (1956) provides: "Declining balance method— (a) Application of method—. . . While salvage is not taken into account in determining the annual allowances under this method, in no event shall an asset (or an account) be depreciated below a reasonable salvage value. . . ."

salvage value under the straight line method. The average holding period of the automobiles was seventeen months. The Commissioner claimed useful life was seventeen months and salvage value was market value at the end of the seventeen months. The Supreme Court of the United States reversed the decision of the Court of Appeals for the Ninth Circuit that the Commissioner had used erroneous concepts of useful life and salvage value, and ruled in favor of the Commissioner, stating that useful life was the period of use by the taxpayer in his business, and that salvage value was resale value at the time of disposal, and not junk value as claimed by the taxpayer. *Commissioner v. Evans*, 346 U.S. 92 (1960).

In the third and final case, taxpayer was a Chrysler dealer who rented new cars to a finance company, and assigned new cars to company officials. These cars were useful to the business for less than one year, and straight line depreciation was taken on a useful life of three years. No salvage value was allowed, and the cars were sold after their brief use for more than their cost price. The years in dispute were 1950 and 1951. The Commissioner claimed useful life was less than one year, and that no depreciation should be taken because salvage value exceeded the original cost. The Court of Appeals for the Fifth Circuit rendered a decision in favor of the Commissioner. The Supreme Court affirmed this decision, using the same rationale as in the *Evans* case. *Massey Motors Inc. v. United States*, 346 U.S. 92 (1960).

The *Hertz* case was decided under the 1954 Internal Revenue Code and *Evans* and *Massey* were decided under the 1939 Internal Revenue Code. The taxpayers contended that useful life is the economic life of an asset, regardless of who the owner might be. The Commissioner contended that useful life is the time in which the asset is actually used by one taxpayer. Ordinarily, one cannot determine how long he will use the asset, but in these cases, all knew that they would hold their respective assets for a period considerably shorter than their economic lives. The government claimed that when an owner is reasonably certain that an asset will not be kept until the end of its economic or physical life, he must depreciate the asset over the expected holding period and account for the salvage value as the expected market price at the time of disposal. Taxpayers claimed depreciation over the physical life of the asset, and accounted for salvage value as junk value after complete deterioration of the asset. The taxpayers availed themselves of greater depreciation by their method in that they did not have to account for a higher salvage value upon disposal, since under this method salvage was only junk value. This will allow the taxpayers to decrease ordinary income, subject to a maximum fifty-two per cent corporate income tax, and increase capital gains, subject to a twenty-five per cent income tax.

The three cases, as above indicated, were considered by the Supreme Court at the same time. All dealt with the meaning of useful life and with the requirement of salvage value at the end of useful life. The government and the courts have been inconsistent in their application of "useful life."³ Their present interpretation of useful life as the period during which the taxpayer anticipates retaining the asset in the business, is not without prior authority.⁴ However, in the past, the government and the courts seem to have applied useful life as physical life more often than as life to the individual. In 1927, the Board of Tax Appeals upheld the government's contention that automobiles used in a business two to three years had useful lives of four to five years.⁵ In 1956, the Court of Appeals for the Third Circuit held, in reversing a tax court decision that exposing property for sale does not change the character of the asset:

The essence of the tax court's alternative ground is that property changes character merely by the fact of its being exposed for sale. We agree with the taxpayer that such a concept is neither logical or reasonable.⁶

In 1959, the Commissioner asked for a four year useful life on rental vehicles which were used in the taxpayer's business for periods varying from twelve to sixteen months. A subsequent agreement between the petitioner and the Commissioner stated that a four year useful life was proper.⁷ In *Herbert Schainberg*,⁸ the government pleaded that physical life and useful life are the same. They stated in their brief:

The physical life of the component parts of the buildings is a prime factor to be considered in determining useful life of the assets. Presumably, unless other factors are present which would reduce the physical life of an asset, there is no reason why the physical life and the useful life would not be the same.⁹

³ In some instances, they have interpreted useful life as physical life of an asset (*Charlie Hillard*, 31 T.C. 961 (1959)); while in other instances they have interpreted useful life as expected life to an individual owner (*United States v. Ludey*, 274 U.S. 295 (1927)).

⁴ *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943); *United States v. Ludey*, 274 U.S. 295 (1927); *Cohn v. United States*, 259 F.2d 371 (6th Cir. 1958); *St. Louis Co. v. United States*, 134 F. Supp. 411 (D. Del. 1955). These cases are substantiated by *Treas. Reg. § 1.167(a)-1(b)* (1956), which provides: "Useful life—For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. . . ."

⁵ *Whitman-Douglas Co.*, 8 B.T.A. 694 (1927); *Max Kurtz*, 8 B.T.A. 679 (1927).

⁶ *Philber Equip. Corp. v. Commissioner*, 237 F. 2d 129, 133 (3rd Cir. 1956).

⁷ *Charlie Hillard*, 31 T.C. 961 (1959).

⁸ 33 T.C. Bk. No. 28 (1959).

⁹ *Id.* at 54.

It would therefore appear that the position of the government in *Hertz*, *Evans*, and *Massey* was not consistent with the line of reasoning followed by the government in past decisions.¹⁰

Salvage value determination is closely linked with the determination of useful life. If useful life is the physical life of the asset, salvage value will be junk value. However, if useful life is the period of use of a particular taxpayer in his trade or business, then salvage value is the estimated resale value at the expected time of sale. The Court in the *Hertz*, *Evans*, and *Massey* cases has held that salvage value must be reasonable at all times, and that therefore an asset cannot be depreciated below a reasonable salvage value. This appears to be a justifiable decision, and one that should not be subject to an excessive amount of controversy. There is considerable authority supporting the Commissioner's viewpoint on salvage value.¹¹ *Hertz*, *Evans* and *Massey* established that salvage value must at all times be reasonable regardless of the depreciation method used, and that the remaining salvage value in the declining balance equation is not necessarily a reasonable salvage value.

A major effect of the Court's decisions is that depreciation is to be calculated over the estimated useful life of the asset while actually used by the taxpayer, and not over the period of its economic life. Thus, a taxpayer, when purchasing a new asset, will not be allowed the use of the double declining balance and the sum of the year-digits depreciation methods unless the asset is to be used by him in his trade or business for at least three years.

The extent to which a taxpayer may avail himself of capital gains treatment on depreciable assets intended for use during a shorter period than physical life is reduced by the Court's decision on salvage value and useful life. This is so because yearly depreciation deductions will be reduced, thus increasing ordinary income, subject to a fifty-two per cent tax, and book value will be increased, thus decreasing the capital gain on the sales, subject to a twenty-five per cent tax.

It appears that legislation will eventually be passed to correct the inequities in the application of the capital gains provisions.¹² A reasonable treatment would be to record all gains on sales of depreciable personal property as ordinary income, and thus eliminate the maneuvering of tax experts to reap unwarranted benefits for their clients through the utilization of the lower capital gains income tax rates. The enactment of such

¹⁰ The government's ideas are commendable because taxpayers such as *Hertz*, *Evans*, and *Massey*, are not within the group intended to be benefited by the capital gains provisions of the 1954 Internal Revenue Code.

¹¹ Cases cited note 7 *supra*.

¹² Herbert Schainberg, 33 T.C. Bk. No. 28 (1959).

legislation would allow the Commissioner to more readily accept taxpayer judgment of useful life and salvage value, and hence depreciation provisions of the Internal Revenue Code would be adhered to with greater conformity by the taxpayer.

PATENTS—NEW CRITERION FOR DETERMINING VALIDITY OF BROADENED CLAIMS IN REISSUED PATENTS

Plaintiffs sued defendant for infringement of reissued patent No. 23,937, relating to a lapping machine. Plaintiffs asserted infringement of six claims¹ which were identical to claims in the original patent, and also alleged infringement of four new and broader claims which were added by reissue. Defendant denied infringement of the six identical claims as well as the four new and broader claims, and further asserted invalidity of the reissued patent. The District Court for the Northern District of Illinois held the six identical claims invalid for lack of invention and held the four new and broader claims invalid because of public use of the subject matter claimed therein for more than one year prior to the filing date of the reissue application.² The Court of Appeals for the Seventh Circuit affirmed the lower court's finding of invalidity as to the identical claims, and also sustained its interpretation of those sections of the 1952 Patent Act relating to reissued patents,³ and thereby held that the four new and broader claims were invalid. This pronouncement established that public use or sale of the subject matter defined in the claims of the reissued patent for more than one year prior to the filing date of the reissue application invalidates those claims in the reissued patent which are not identical to claims in the original patent. *Crane Packing Co. v. Spitfire Tool & Machine Co.*, 276 F. 2d 271 (7th Cir. 1960), *cert. denied*, 363 U.S. 820 (1960).

The holding of the court of appeals which is a substantial limitation, if not a total nullification of the law relating to reissued patents, establishes

¹ The function of claims in a patent was considered by the Supreme Court in *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502 (1917), wherein it is stated: "The scope of every patent is limited to the invention described in the claims contained in it, read in the light of the specification. These so mark where the progress claimed by the patent begins and where it ends that they may have been aptly likened to the description in a deed, which sets the bounds to the grant which it contains. It is to the claims of every patent, therefore, that we must turn when we are seeking to determine what the invention is, the exclusive use of which is given to the inventor by the grant provided for by the statute, 'He can claim nothing beyond them.'" *Id.* at 510.

² *Crane Packing Co. v. Spitfire Tool & Machine Co.*, 177 F. Supp. 927 (N.D. Ill. 1959).

³ 35 U.S.C.A. §§ 251-52 (Supp. 1959).